Testimony before the U.S.-China Economic and Security Review Commission

Joel Backaler
Director, Frontier Strategy Group &
Author of *China Goes West* (Palgrave Macmillan, 2014)

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Hearing on US-China Economic Challenges:
Panel III: Chinese State-Owned Enterprises and Non-Market Economics – Competitive Challenges

Mr. Chairman and members of the Commission, thank you for the opportunity to appear before you today. My name is Joel Backaler and I am a Director at Frontier Strategy Group, a Washington DC-based advisory firm that supports American multinationals' entry and operation in emerging markets. I am also author of the forthcoming book *China Goes West*, published by Palgrave Macmillan. The book analyzes the drivers and implications of Chinese firms' global expansion, with a particular focus on Chinese companies investing in the United States and other advanced economies. I previously worked as a consultant for both private and state-owned Chinese companies on the ground in China.

This written statement summarizes key findings from my research on Chinese state-owned and private firms and their overseas expansion.

State vs. Private: A Blurred Line

The use of "Chinese state-owned enterprises" as a homogenous term in current policy discourse belies their variation and structural complexity. Central state-owned enterprises are managed by state ownership agency SASAC (State-owned Assets Supervision and Administration Commission), which combines both ownership and regulatory functions.[1] Each central state-owned enterprise itself comprises a complex, multi-layered 'business group', the apex of which is a state holding corporation.[2] Below the state holding corporation are myriad subsidiary firms, some of which may be publicly listed on stock exchanges in China and

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[1]SASAC exercises state authority by its direct involvement in personnel appointment, setting annual performance targets, and conducting performance evaluation for the companies it manages. However, SASAC does not directly manage firm operations or decision-making about investments; firm leaders and companies retain significant autonomy in these areas.

[2] Industry-based analysis of business groups is complicated by the fact that subsidiaries frequently have investments outside of the holding company's core industry at home and overseas. For example according to the China Iron and Steel Association (CISA), non-steel business turnover of China's seven largest steelmakers accounted for 23 per cent of their total revenues as of 2013.

overseas. SASAC has sought since its founding in 2003 to introduce modern corporate governance institutions such as boards of directors and supervisory boards. But while corporate governance institutions have been established in central state-owned enterprises' publicly listed subsidiaries and an increasing number of state holding corporations, the fact that the newly-created Board Chairman is also the Party Secretary in virtually all companies suggest this has not fundamentally changed existing authority structures.

It is important to note that government support of Chinese firms—both financial and political—is not limited exclusively to state-owned enterprises. This assumption can be misleading. For example, Haier, the Chinese consumer appliance maker positions itself as a 'collective firm'; however, it relied on the municipal government of Qingdao for support ranging from loans, free land use, and even government-brokered acquisitions of failing Chinese SOEs in the consumer appliance industry.[3] Moreover, Haier—as an ostensibly private company—is the only non-state-owned enterprise managed by Qingdao's SASAC.[4] It is wrong to think that state-owned companies are the only firms with ties to the Chinese government and recipients of financial and political support from the state.

The Third Plenum & State Sector Reform in China

In November 2013, The Third Plenum of the 18th Central Committee of the Chinese Communist Party (CCP) presented the Xi administration's agenda for the next stage of reform to China's state-owned sector. While affirming the enduring importance of state-owned enterprises, it emphasized the market's "decisive" role in resource allocation and expressed the new administration's intention to build a more even playing field between state-owned and private enterprises. Gradual economic reform achieved through increased market competition—rather than ownership change—has long characterized China's approach to economic reform. Far-reaching reform to the state-sector remains unlikely given the powerful interest groups and individuals within the Party who profit from the current status quo.[5]

Yet the Third Plenum reforms have not unequivocally buttressed Chinese state-owned enterprises' position vis-a-vis private Chinese firms. One of the most important indicators of this is the intention expressed in the Third Plenum reforms to introduce greater competition in non-strategic sectors to break up monopolies and let SOEs face more competition from private Chinese companies. SOEs currently operating in "non-strategic" industries such as restaurants, retailing and low-end

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[3] Caijing Guancha. "Guoyouqiye haishi jiti qiye? Haier jituan chanquan xingzhi zhibian." 7 July 2004. Web. [http://gb.cri.cn/7212/2004/12/07/1166@ 383635.htm].

[4] From SASAC.gov.cn: "The relationship between SASAC and state-owned assets supervision and administration bodies at provincial and municipal (regional) levels is to fulfill the responsibilities of investors of state and local assets authorized by the State Council and the provincial and municipal (regional) governments respectively."

[5] Naughton, Barry. "The Narrow Road to Reform." 7 October, 2013. [http://media.hoover.org/sites/default/files/documents/CLM42BN.pdf]

manufacturing are significant — according to Ministry of Finance data, over 90,000 individual enterprises with approximately 37 trillion *renminbi* (6 trillion USD) operate in "non-strategic" sectors.[6] Despite opposition from vested interests within the state and Party itself, Chinese leaders have important motivations to continue and deepen reform of the state-owned sector, including: decreasing government liabilities, strengthening budget constraints, and improving the quality of state-owned companies' goods and services through greater market competition.

Chinese Firms and Overseas Direct Investment

Chinese companies of varying ownership structures expand internationally due to both governmental and commercial motivations.[7] The "go out" policy, formally launched in 2000 during the 10th 5-year plan, remains the primary policy framework through which the government supports Chinese overseas investment. By encouraging Chinese firms' international expansion, the government can secure the natural resources necessary to fuel China's economic growth while bolstering economic ties with friendly regimes. In addition, internationalization of the state-owned sector provides the Chinese government with a channel to invest its vast foreign exchange reserves while boosting long-term economic growth. The development of national champions in strategic industries helps China expand its political as well as economic influence through soft power.

From a domestic perspective, the business case for Chinese companies to 'go out' is very strong. The domestic market in China is fiercely competitive and Chinese firms require advanced technology and global management best practices to stay ahead of competitors back home. Acquiring global brands through mergers and acquisitions help bridge the trust gap for Chinese companies seeking to connect with an international audience for the first time, or to rebrand their firm as a high-end alternative for the domestic Chinese market. Most importantly, international expansion opens new markets to grow Chinese firms' businesses and become less reliant on a slowing Chinese economy.

Chinese overseas direct investment (ODI) has been - and continues to be - dominated in terms of overall amount by state-owned enterprises. However, a trend in which the proportion of ODI constituted by private Chinese companies' investments comprising a greater proportion of total ODI flows has already appeared. In 2012, private Chinese firms accounted for 9.5% of China's ODI representing a substantial increase from just 4% in 2010.[8] If the reforms announced at the Third Plenum are implemented, this trend will only accelerate further. Another important trend is the shift in the focus of Chinese firms' ODI beyond

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[6] Batson, Andrew. "Fixing China's State Sector." January 2014 [http://www.paulsoninstitute.org/media/117965/fixingchina_sstatesector_english.pdf

[7] For a detailed overview of the motivations for Chinese firms to invest overseas – see Chapter 2 titled, *Fleeing the Great Game: Why Are Chinese Companies Going Global?* in *China Goes West* (Palgrave Macmillan, April 2014).

[8] "The expanding scale and scope of China's outward direct investment," The Economist (Jan. 19, 2013).

resources to industries including consumer goods, manufacturing, and entertainment. The U.S. and EU's slow recovery from the global financial crisis has undoubtedly expedited the frequency and scale of Chinese companies' investments overseas.

However, what we know about Chinese SOEs' ODI in terms of data outside of developed markets remains limited for several reasons. First, China's Ministry of Commerce (MofCOM) statistics do not give firm-level investment data and includes only investments above $10 million. Second, for the central SOEs that do have publicly listed subsidiaries, we only have reliable investment data for those subsidiaries and not their other subsidiaries with investments overseas or the overall holding companies. Third, even within these companies there is an information problem as corporate headquarters struggles to get accurate economic data from subsidiary firms. They attempt to control subsidiaries—but with various degrees of success—through methods including: executive personnel control; centralized information management systems; one-level-up decision-making; and budget controls.

Recommendations for the United States

The United States has much to gain from the global emergence of Chinese companies, including: employment generation, tax revenues, potential investors in domestic infrastructure, and new market access. However, there are important reasons why Chinese investments should not all be welcomed, such as: concerns about national security, cyber-security, and anti-competitiveness. Targeted efforts must be made to ensure that Chinese investment in the US is mutually beneficial at the government, corporate, and individual levels. Below I offer a series of recommendations[9] for the American government to maximize the benefits of Chinese ODI, while mitigating potential anti-competitive, cyber security or national security concerns.

i. Remove politics from investment review to the greatest possible extent

Last year, Chinese state-owned Shuanghui International acquired complete ownership of American pork producer Smithfield Foods in a $4.7 billion deal. But before the Committee on Foreign Investment in the United States (CFIUS) scrutiny of the deal even began, politicians started to appear on major news networks expressing their "concerns" about food safety and product quality, despite the fact that government oversight of the firm's products would not change. The ongoing politicization of high-profile Chinese investments perpetuates the myth that Chinese investment is not welcome in the U.S. In fact, the data shows that the vast majority of attempted Chinese investments are successfully completed without government interference. But if the US is seen by Chinese firms as "unwelcome to Chinese investment" as a result of unclear, inconsistently applied, or politically motivated

[9] For a complete set of recommendations across the government, corporate and social spheres – both in China and the US – see Chapter 8 titled, *The Response: Maximizing Benefits, Minimizing Concerns* in *China Goes West* (Palgrave Macmillan, April 2014).

regulatory procedures will miss a tremendous opportunity to benefit from Chinese investment.

ii. Consider political priorities, focus on economic factors

The U.S. should consider political priorities, but focus on economic factors and communicate from the senior government level down that Chinese investment is welcome. This message should begin with an official statement and be reinforced by trade dialogues, bilateral forums and on the Internet. Messaging needs to be targeted toward the relevant Chinese investors for a particular industry or location of investment. It should also be made as accessible as possible through multiple channels. For example, many Chinese businesspeople may feel more comfortable reviewing only FAQ's and chatting informally through one-on-one Internet messaging tools with SelectUSA[10]'s representatives rather than attending a live Q&A session. It is critical that all communications are in Mandarin—leave no room for misinterpretation. Clear, consistent, and regularly repeated messaging will strengthen bilateral communication on investment issues. At the same time, these communications will help to provide a more objective economic context for any domestic voices that might focus solely on political factors.

iii. Remedy the disconnect between federal and state levels in the U.S.

In China, SelectUSA primarily fulfills its mission by traveling to various provinces and hosting events at which Chinese firms interested in investing in the U.S. can learn more about the American business environment. At the same time, a small group of U.S. state governors and city mayors visit China on trade missions to selectively recruit Chinese investment and introduce specific projects in their individual regions. State representatives may partner with one of 33 U.S. state trade offices in China.

This situation clearly illustrates the disconnect between federal and state efforts to promote Chinese investment. Through SelectUSA, the federal government cannot recommend particular industries or locations where Chinese companies should invest. Therefore, the only specific guidance Chinese investors receive is often from state government officials traveling to China for trade missions. Such state officials are incentivized to promote their own interests—seeking out job creation and tax dollars that will fuel their local economies.

The U.S. should bridge this federal-state gap by adopting a more systematic and coordinated approach to promoting investment from Chinese companies. With small trade offices in China, irregular governor visits from some states, and

[10] SelectUSA was established by Executive Order of the President and is housed within the U.S. Department of Commerce. SelectUSA is a U.S. government-wide effort to encourage, facilitate, and accelerate business investment in the United States by both domestic and foreign firms—a major engine of economic growth and job creation.

understaffed federal agencies, actors at the state and federal levels should be working together to attract investment and to consistently communicate information about investment regulations and procedures. Instead, in some cases levels are competing with each other, or providing inconsistent information to potential Chinese investors.

iv. Improve data accessibility

Chinese overseas investment can be clearly quantified if the U.S. government can adopt a more coordinated approach to data collection. For example, several state investment recruitment agencies create "Project Profiles" for proposed investments from China and other overseas investors. The project profile measures the potential net economic impact of an investment to their local economy by documenting expected job creation, land and building use, energy consumption, and a range of other factors. Successful investments are documented and tracked by local agencies. If such data were collected and reported in a consistent manner at the state level in the U.S. then a centralized federal dataset would paint a highly accurate picture of the nature and volume of Chinese investment in the US. The resulting data could help indirectly inform Chinese businesses about where they should consider investing based on the industry distribution of the already documented investment cases. Meanwhile, the dataset could serve as a valuable means to encourage greater cooperation among the various government stakeholders competing for Chinese investment in their respected regions.

v. Adopt a dual online-offline strategy

To supplement its live forums, SelectUSA would be wise to learn from Germany's Trade & Invest, the economic development agency of Germany, and create a Chinese language website with a detailed Q&A section addressing common concerns. SelectUSA could also go a step further and use Chinese social media tools such as Weibo, WeChat, and QQ instant messenger to engage with Chinese businesspeople one-on-one to answer their individual questions. This would ensure that the US has a "24-hour storefront" in China. In addition, SelectUSA would gain valuable intelligence about Chinese investors, enabling it to identify common characteristics, concerns, and trends to improve its engagement strategy. A dual online-offline approach is best suited for the current stage where SelectUSA's staffing capacity is simply not sufficient to meet potential Chinese demand across more than 30 provinces.

Appendix: Selected Tables & Figures from *China Goes West*

Chinese companies are young and learning.
"In many industries Western firms have had decades or even a century more of operating experience compared with their Chinese competitors. In contrast, Chinese firms' rapid growth trajectory means that they are learning how to develop their business while transforming into global industry giants at the same time." (p. 11)

Table 1.1 Comparison of Chinese vs Western firms by years of experience

Industry	Western company	Founded	Chinese company	Founded
Home Appliances	Electrolux	1910	Haier	1984
Beverages	The Coca Cola Company	1892	Jianlibao	1984
Athletic Apparel	Nike	1964	Li-Ning	1990
Medical Devices	Roche	1896	Mindray	1991
Oil & Gas	Chevron	1879	PetroChina	1999

Chinese state-owned enterprises may operate across different business areas.
Chinese state-owned chemical firm ChemChina operates a subsidiary under its BlueStar group called Malan Noodles. Malan Noodles is one of the largest fast food noodle restaurants in all of China. (p. 25)

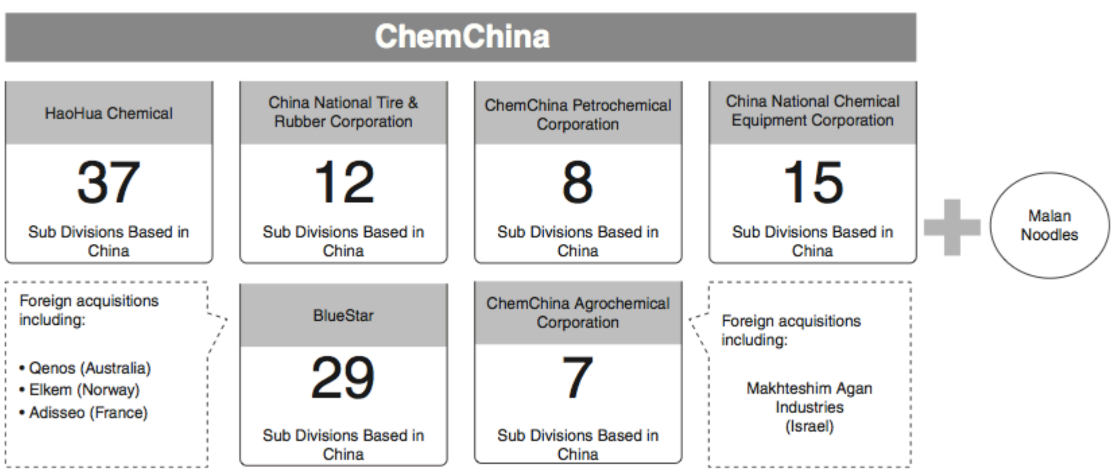

FIGURE 1.2 ChemChina domestic and overseas subsidiaries
Source: Author's own image, statistics from ChemChina.com.